

Chapter 12

Summary . . .

Coordination and Accountability

Overview

- This chapter recommends changes in the funding, governance and external review of the financial regulatory agencies which are intended to contribute to more effective regulation.

Key Recommendations

- The Australian Prudential Regulation Commission (APRC) and the Corporations and Financial Services Commission (CFSC) should establish their own staffing and remuneration structures in whatever form will be most conducive to their effectiveness and efficiency. They should locate their headquarters in the main financial capitals, rather than Canberra. Their inspection staff should be located in the cities where the financial industry operates.
- The regulatory agencies should collect from the financial entities which they regulate enough revenue to fund themselves, but not more. Their fees and charges should be determined by the agencies, subject to approval by the Treasurer.
- The restriction on interest payments on non-callable deposits (NCDs) held by banks at the Reserve Bank of Australia (RBA) should be reviewed before building societies and credit unions are made subject to the NCD requirement.
- The regulatory agencies should have boards of directors responsible for their operational and administrative policies, the fulfilment of their respective legislative mandates and their performance.

- These new boards should have majorities of independent members and substantial cross-representation.
- A Financial Sector Advisory Council should be established, with members appointed by the Treasurer. It should advise the Treasurer on:
 - progress of implementation of new regulatory arrangements, and their effects on the financial sector and the economy;
 - new and potential developments in the financial system and their regulatory implications;
 - the cost effectiveness and relevance of the regulatory framework for the financial system;
 - the compliance costs occasioned by financial regulation; and
 - the international competitiveness of Australia's financial sector and how Australia could become a preferred location for financial activities in the region.
- Legislation should authorise the exchange of confidential information among the RBA, APCR and CFSC.
- The Council of Financial Regulators should facilitate the cooperation of its three members—the RBA, APCR and CFSC—across the full range of regulatory functions and their attainment of regulatory objectives with the minimum of costs.

Coordination and Accountability

12.1 Introduction

This chapter makes recommendations for improving aspects of the operation of the financial regulatory agencies — their coordination and accountability — including arrangements for their funding, governance and ongoing review.

The recommendations in this chapter are intended to satisfy the principles for effective regulation set out in Chapter 5. The regulatory agencies should:

- have an explicit mandate to balance efficiency and effectiveness;
- be accountable to their stakeholders;
- operate independently of sectional interests;
- be funded by those benefiting from their activity;
- be allocated functions in a way which minimises overlaps, duplication and conflicts;
- have appropriately skilled staff; and
- have flexibility and be subject to regular reviews.

12.2 Regulatory Performance

12.2.1 Legislative Basis

The existing major financial regulatory agencies are established under legislation providing for their existence, their chief executives, their mandates and powers, and certain other aspects of their operations. This status affords a degree of autonomy with respect to the executive government which provides public confidence in their impartiality in exercising discretion and applying the law.

This same autonomy should be provided to the new regulatory agencies recommended by the Inquiry — the Australian Prudential Regulation Commission (APRC) and the Corporations and Financial Services Commission (CFSC). Indeed, there is a strong case for increasing autonomy in a number of areas such as licensing.

12.2.2 Staffing and Remuneration

The APRC and CFSC should be fully conversant with the entities and markets they regulate and meet industry standards in their expertise. This can be achieved without jeopardising their necessary institutional qualities of impartiality and dedication to the public interest.

Effective regulation will also depend on the following factors.

- **Ensuring adequate resources** — this is addressed in the section below about funding. The Inquiry's recommendations for the financial regulatory agencies will not increase their overall resource needs. Indeed, they may lead to some savings.
- **Providing autonomy in determining staffing structures and remuneration** — this departs from the current practice for the Australian Securities Commission (ASC) and the Insurance and Superannuation Commission (ISC) which are part of the Commonwealth public service. Greater freedom in staffing and remuneration would not put at risk the agencies' economy in

operation provided they were sufficiently accountable. It could be used to:

- match more closely the skill mix and remuneration of private entities in the financial industry;
 - develop and maintain an appropriate balance of expertise, including in law, enforcement, economics, finance and information technology; and
 - develop systems for internal and external rotation of staff.
- **Ensuring physical proximity to markets** — the headquarters of the APRC and CFSC should be located in the main financial capitals, rather than Canberra. The APRC's and CFSC's operational and policy functions should be located in centres where financial institutions are headquartered and where substantial financial markets operate. The agencies may need a local presence for inspections, and they should be free to locate their representative, processing or other support functions wherever they think most efficient.

Recommendation 103: Regulatory agencies should have operational autonomy.

The regulatory agencies should be established under legislation with substantial operational autonomy.

The APRC and CFSC should establish their own staffing and remuneration structures in whatever form will be most conducive to their effectiveness and efficiency.

The APRC and CFSC should locate their headquarters in the main financial capitals, rather than Canberra. Inspection staff should be located in the cities where the financial industry operates.

12.3 Funding

For reasons of equity and efficiency, as a general principle the costs of financial regulation should be borne by those who benefit from it. This principle must, however, be applied in a practical way.

The most practicable means is for industry to be levied to meet the cost of regulation incurred by regulatory agencies, with each industry levied in proportion to the agency resources expended on it. The arrangements should involve a mix of direct service fees and annual levies and should distinguish, where possible:

- services provided at the instigation of individual entities, such as authorisations or registrations, for which per-item cost recovery fees are appropriate; and
- regulatory activities undertaken at the discretion of the agency and for the general benefit of customers, such as inspections, enforcement and policy development, for which annual industry wide levies are most appropriate.

Within the bounds of practicality, levies should be related to broad categories of cost, so that those activities which have a low regulatory cost are not charged effectively to cross-subsidise those which have a high regulatory cost.

From the perspective of equitable and efficient regulation of the financial sector, over-recovery of costs is as questionable as under-recovery. In either case, there is a transfer of resources which might cause inequity or impair allocative efficiency.

Recommendation 104: Regulatory agencies' charges should reflect their costs.

The regulatory agencies should collect from the financial entities which they regulate enough revenue to fund themselves, but not more. As far as practicable, the regulatory agencies should charge each financial entity for direct services provided, and levy sectors of industry to meet the general costs of their regulation.

12.3.1 Non-Callable Deposits

The Reserve Bank of Australia (RBA) currently earns substantial additional income through setting the interest rate on the non-callable deposits (NCDs) which it requires from authorised banks at a rate well below market. This income substantially exceeds the internal cost to the RBA of its regulatory function in respect of authorised banks.

It may be argued that the excess can be viewed as a levy which the RBA (or the Government as its owner) collects in return for:

- the possibility of assistance to the banks in case of financial emergency — roughly analogous to an insurance premium; or
- the status in the financial marketplace conferred on banks by their authorisation — roughly analogous to a franchise fee.

The Inquiry considers there is very little merit in the ‘insurance premium’ view, since it does not accept that it is the role of the RBA to provide such support for banks. In fact, supporting banks in emergencies has cost the RBA virtually nothing in its history and this is likely to remain so in the future. Similarly, the ‘franchise fee’ view has little merit.

The excess charge through NCDs creates a considerable regulatory distortion between banks and non-banks. For example, money market corporations (‘merchant banks’) compete in a number of significant markets directly with licensed banks without the cost disadvantage of NCDs.

The Inquiry observes that NCDs would be dissociated substantially from the function of prudential regulation of banks if the Inquiry’s recommendations about establishing the APRC are adopted. The Inquiry also observes that imposing the excess charge through NCDs on building societies and credit unions under the recommended scheme of authorisation, while reasonable on grounds of competitive neutrality, could impede this reform.

The excess charge through NCDs is effectively a disguised tax and, as such, is outside the scope of the Inquiry’s recommendations. The Inquiry’s observations are restricted to those relating to its implications for the financial system. In particular, the merits of the NCD arrangements as a tax have not been assessed relative to any alternative revenue source.

Recommendation 105: Interest on non-callable deposits should be reviewed.

The collection of revenue by the RBA through the restriction on interest payments on non-callable deposits creates distortions in financial markets and is not consistent with the principles for funding financial regulation. It should be reviewed by the Commonwealth before building societies and credit unions are made subject to a requirement for non-callable deposits.

12.3.2 Determination of Regulatory Fees and Charges

The fees and charges through which the financial regulatory agencies collect revenue to cover their costs of operation should not be determined entirely by the agencies themselves, but should be subject to approval by the Treasurer, who is in turn accountable to the Parliament. Otherwise the regulatory agencies would operate within a structure biased towards over-extension.

Recommendation 106: Regulatory agencies should set their charges, subject to approval by the Treasurer.

Fees and charges imposed to recover costs of the financial regulatory agencies should be determined by the agencies, subject to approval by the Treasurer.

12.3.3 Budget Funding of Regulatory Agencies

There is a further question of whether the finances of the two new financial regulatory agencies, the APRC and CFSC, should be separated from, or insulated within, the Commonwealth Government's budget (the ASC and ISC are currently funded through that budget, while the RBA is separate).

From the perspective of financial regulation, it is preferable that the APRC and CFSC operate off-budget. If the principle of direct recovery of their regulatory costs is followed, that would be practicable. The Inquiry's recommendations about accountability are intended to provide enough checks and balances for these agencies to operate off-budget without their size and cost becoming excessive.

The Inquiry acknowledges that the CFSC would be likely to have some functions continued from the ASC apart from its financial regulatory functions, which might complicate the model; and that operating off-budget raises issues of Government wide policy about the financial freedom or limitation of statutory authorities, which the Inquiry has not examined.

If the APRC and CFSC are to be funded through the Commonwealth Government's budget, their funding should be determined by reference to policies for financial system regulation rather than targets for the overall budget balance. Their funding would not affect these targets because the costs of the agencies' regulatory functions would be recovered from regulated entities.

Recommendation 107: Regulatory agencies should be off-budget.

From the perspective of financial regulation, it is preferable that the APRC and CFSC operate off-budget.

If they are funded through the Commonwealth Government budget, they should have their funding levels determined by reference to policies for financial system regulation rather than to targets for the overall budgetary balance.

12.4 Governance

The APRC and the CFSC should have boards of directors to determine their operational and administrative policies, to ensure that they fulfil their respective legislative mandates and to monitor their performance. In the case

of the RBA, which already has such a board, the Inquiry recommends (in Chapter 9) the formation within the RBA of an additional Payments System Board (PSB).

Each of these new boards (APRC, CFSC and PSB) should be chaired by an independent member, rather than the agency's chief executive, in order to encourage a broad perspective and underline the accountability of management to the board. This would imply a limited modification of the principle embodied in the current positions of the Insurance and Superannuation Commissioner and ASC Chairman, who as statutory officers have the supreme responsibility within their organisations and are accountable directly to the Treasurer. The chief executives of the APRC and CFSC should be accountable to boards of directors which, through their chairpersons, can report separately to the Treasurer. At the same time, the APRC and CFSC chief executives should be directly responsible for enforcement actions, and not required to act in those matters under board direction. They should be statutory officers appointed on the nomination of the Treasurer rather than by their agencies' boards.

The chairpersons and other board members would need to distinguish carefully their responsibility at policy level from the responsibility of the agencies' executives for enforcement actions and avoid adopting policies or procedures which would impede enforcement action.

The independent members of these regulatory agency boards should have financial industry expertise or other expertise (including expertise in consumer protection) relevant to the agencies' functions. They would serve independently as individuals and not as representatives of any sectional interest.

Accordingly, if the regulatory agencies need to obtain the views of particular sections or groups, they would be obtained from advisers separate from the boards.

The financial regulatory agencies should have substantial board cross-representation to encourage cooperation and foster a common perspective about the needs and dynamics of the financial system.

Conflicts of interest are an obvious potential problem for independent board members, but should not rule out the appointment of members for whom conflicts might arise. Conflicts should be managed through some limitations in the selection of board members to avoid frequent and severe conflicts of interest and through rules of board procedure.

Recommendation 108: Regulatory agencies should have boards, with majorities of independent directors.

The regulatory agencies should have boards of directors responsible for their operational and administrative policies, the fulfilment of their respective legislative mandates and their performance.

The key principles in the composition of these new boards are that there should be majorities of independent members and substantial cross-representation.

The following board compositions are illustrative and not prescriptive.

- APRC — six independent members appointed on the nomination of the Treasurer, three ex officio members from the RBA including the Governor, a deputy governor and an ex officio member of the PSB, the chief executive of the CFSC, and the chief executive of the APRC (appointed to that office on the nomination of the Treasurer).
- CFSC — six independent members appointed on the nomination of the Treasurer as part-time Commissioners, three full-time Commissioners including the chief executive (appointed to those offices on the nomination of the Treasurer), the Governor or a deputy governor of the RBA, and the chief executive of the APRC.
- PSB — five independent members appointed on the nomination of the Treasurer, the Governor of the RBA and two other RBA officers nominated by the Governor, and an officer nominated by the chief executive of the APRC.

The chairpersons of the APRC and CFSC boards and the PSB should be appointed by the Treasurer from among the independent members.

12.5 Accountability

12.5.1 Reporting

Accountability of the financial regulatory agencies requires that each should make regular, detailed public reports on its operations, and on its sources and uses of funds. This is required of other statutory authorities, whether or not funded from the Commonwealth Government's budget. Accountability includes being answerable to the Parliament, through the Treasurer as responsible Minister.

Accountability of each of the financial regulatory agencies should also include identifying:

- the costs of each regulatory activity, separately and to the extent necessary to enable equitable and efficient cost recovery from regulated entities;
- the costs for regulated entities of compliance with the regulation which the agency administers;
- the agency's efficiency and effectiveness in performing its regulatory functions; and
- the extent to which the agency meets community expectations in a dynamic industry setting.

The Inquiry considers that efforts to improve the standard of the annual reports of the financial regulatory agencies should focus on these areas, especially program accounting, monitoring of compliance costs and realistic assessments of cost effectiveness. Identifying the best practices of other international regulators as comparators may be helpful.

In the framework recommended by the Inquiry, all three of the financial regulatory agencies would have several complementary objectives. The RBA would be responsible for monetary policy, systemic stability and regulation of the payments system. The CFSC would be responsible both for market integrity and for consumer protection. The APRC would be responsible for prudential regulation in different forms and intensities. These multiple objectives should remain in balance and none should be eclipsed. Therefore,

each agency should separately identify its performance against its major regulatory objectives.

Recommendation 109: Regulatory agencies should improve their reporting.

To ensure adequate accountability and to assist the application of efficient cost-recovery arrangements, each regulatory agency should develop internal accounting systems and reporting arrangements to identify its effectiveness and efficiency, both in aggregate and in respect of each major regulatory objective.

Each agency should report annually to Parliament and should seek continuous improvement in reporting quality. Reports should include the results of internal assessments of efficiency, compliance costs and cost effectiveness. Where possible, comparisons with international best practice should be provided.

12.5.2 External Review of Regulatory Agencies

Looking to the medium term, it will be vital to have an external review of the regulatory agencies' operations in order to ensure that the regulatory framework for the financial system is cost-effective and fully relevant (see Recommendations 7 and 34).

Current methods of external review should apply.

- The Auditor-General conducts periodic audits of the regulatory agencies. These audits are wide ranging in their subject matter, include assessments of efficiency, and are the basis of reports to the Parliament.
- The Parliament gathers both information and opinions about the regulatory agencies through its normal operation, especially its standing committees and the conduct of special inquiries.

- The Treasurer, as part of the normal ministerial role, seeks or receives the views of a wide range of people involved or interested in the financial system, including those representing industry associations, and thereby obtains comments on the operations of the regulatory agencies, in addition to advice from Treasury.
- From time to time, independent analysts are commissioned by private sponsors to examine and report publicly on aspects of the financial system regulatory agencies and framework, when a need for this is perceived.

The Inquiry envisages that these current methods of external review will be enhanced through additional public reporting by the financial regulatory agencies containing their assessments of effectiveness, efficiency, compliance costs and cost-efficiency of regulation.

Against this background, the Inquiry considers it unnecessary to establish an additional standing body for the sake of external review of the efficiency of the financial regulatory agencies.

Another aspect of external review is recurrent assessment of how the regulatory agencies' operations fit together as a regulatory framework for the financial system, and as both circumstances and financial practices change, how to keep that regulatory framework cost-effective and fully relevant.

The Inquiry believes it is necessary for an expert advisory body to make periodic assessments of:

- new and potential developments in the financial system and their regulatory implications;
- the cost effectiveness and relevance of regulation of the financial system;
- the compliance costs occasioned by financial regulation ; and
- the international competitiveness of Australia's financial sector and how Australia could become a preferred location for financial activities in the region.

This body should be able to make assessments across the whole financial system and the whole of the regulatory framework, including financial regulation and taxation. This requires a new body — a **Financial Sector Advisory Council (FSAC)**. It should be formed independently of the regulatory agencies, and of the other advisory and user groups which advise individual regulatory agencies, or review particular aspects of financial system regulation. The FSAC would be appointed by, and provide its advice to, the Treasurer. With the Treasurer's agreement, it may also publish reports available to the Parliament and the public. It would take into account, and not seek to duplicate, any efficiency audits of the financial regulatory agencies made by the Auditor-General.

The FSAC would, in its early years, also have a role in advising the Treasurer on progress of implementation of new regulatory arrangements, and their effects on the financial sector and the economy.

The FSAC should not be a statutory body. It should be composed predominantly of people with relevant expertise obtained in private sector entities in the financial industry or closely related industries.

Recommendation 110: A Financial Sector Advisory Council should be created.

A body should be established, named the Financial Sector Advisory Council (FSAC), with members appointed by the Treasurer and with the functions of advising the Treasurer on:

- progress of implementation of new regulatory arrangements, and their effects on the financial sector and the economy;
- new and potential developments in the financial system and their regulatory implications;
- the cost effectiveness and relevance of the regulatory framework for the financial system;
- the compliance costs occasioned by financial regulation; and
- the international competitiveness of Australia's financial sector and how Australia could become a preferred location for financial activities in the region.

12.6 Coordination of Regulatory Agencies

Previous chapters have outlined some instances of required coordination among regulatory agencies, such as monitoring of securities clearing houses.

This section describes the general purpose coordination machinery which the Inquiry believes will be needed.

There are three key reasons why close coordination among the financial regulatory agencies will be vital. The first is that separation of the prudential regulation function from the RBA will, as described in Chapter 8, demand full sharing of relevant information, joint operations of various kinds and standing arrangements for joint handling of emergency situations.

The second reason for close coordination is that financial conglomerates have complex links among their constituent entities of different types. This is especially so for full-service and internationally operating conglomerates. Therefore, in order to meet their individual objectives, the financial regulatory agencies must work in close coordination—sharing detailed information, reaching common views on such things as group wide risk management systems and intra-group financial relations, and if necessary handling jointly any emergencies.

The third reason for close coordination is that rapid, far reaching changes in the financial system are likely to continue. The regulatory agencies will need to work together to understand these changes and all their implications. Unless they cooperate, they are likely to be defeated by the cost and difficulty of assessing financial innovations.

12.6.1 Exchange of Information

From the perspective of financial regulation, it is essential that the financial regulatory agencies (RBA, APRC and CFSC) be able to pass confidential information about financial entities and their operations to one another, whenever this is needed for the purposes of their regulatory functions, provided decisions to do so are made at a senior level within each agency and provided such information remains adequately protected. Each agency should have similar power to share confidential information with

international regulators, when that is necessary for the purposes of its own regulatory functions.

From the perspective of general law enforcement, there are questions about the extent to which the financial regulatory agencies should be empowered or obliged to make the information which they collect from or about financial entities available to other government agencies, such as police forces or the Australian Taxation Office. The Inquiry has not explored these questions and makes no recommendation about them.

Recommendation 111: Regulatory agencies need power to exchange information.

Legislation should authorise the exchange of confidential information among the financial regulatory agencies (RBA, APRC and CFSC).

12.6.2 Council of Financial Regulators

The existing regulatory agencies (RBA, Australian Financial Institutions Commission, ASC and ISC) are members of the Council of Financial Supervisors (CFS) and use it to coordinate their policies and operations in several respects.

When the CFSC and APRC are formed, CFS should be continued with those two agencies and the RBA as members, as a vehicle for ongoing cooperation across the whole range of the agencies' activities. It should be renamed as the Council of Financial Regulators (CFR) to reflect better the common characteristic of the member agencies.

The CFR is best seen as the collaborative dimension of the regulatory agencies' activity, rather than as a separate body with its own ability to make the regulatory agencies cooperate. The key to strengthening the CFR is a commitment by the regulatory agencies to cooperate more closely. The structural features of the CFR are secondary to that.

Similarly, the CFR will rely on maintaining clarity of its scope and frankness in discussions. For this purpose, its membership should not be extended to other agencies or representatives. Its structure, operations and secretariat arrangements should be matters for determination by member agencies. Other vehicles are available to bring a wider range of views to the Treasurer and the Parliament.

The Inquiry does not favour creating a statutory charter for the CFR. This could suggest that the CFR had regulatory functions separate from those of its members, and could engender confusion about whether the regulatory agencies' obligations to coordinate arose from their respective charters or that of the CFR. For the same reason, it is inadvisable for the CFR to participate formally in international meetings.

In the Inquiry's view, in addition to matters receiving attention in the existing CFS, there are several which warrant early attention in the reconfigured CFR. They are noted in the following recommendation.

Recommendation 112: The Council of Financial Regulators should coordinate a broad range of activities.

The Council of Financial Supervisors should be renamed as the Council of Financial Regulators (CFR) and reconfigured with the aims of facilitating the cooperation of its three members (the RBA, APRC and CFSC) across the full range of regulatory functions, and the attainment of regulatory objectives with the minimum of agency and compliance costs.

In addition to implementing these aims, the CFR should give early attention to:

- considering issues of systemic stability spanning their respective jurisdictions, such as the risk characteristics of clearing and settlement arrangements, the risk control systems of futures and options exchanges and other markets, and arrangements for handling situations posing systemic problems;
- monitoring the participation in Australian wholesale markets of large institutions not subject to prudential regulation domestically or overseas;

- harmonising government agencies' data requirements from reporting financial entities, beginning with those of the financial regulatory agencies and Australian Bureau of Statistics;
- liaising with law enforcement bodies about the implications of new financial technology or regulatory practice for enforcement of other laws; and
- examining issues of competitive neutrality in financial regulation which may be suggested from time to time by industry or advisory bodies.

12.6.3 Mega-Regulation

The Inquiry, while recommending measures to ensure close cooperation and coordination among the financial regulatory agencies, has not favoured their amalgamation into a single agency or mega-regulator. The reasons for preferring separate, coordinated agencies to a mega-regulator are:

- it should be expected, and accepted, that agencies formed for the separate purposes of the APRC, CFSC and PSB will function best with their own distinct cultures;
- at this stage in the history of our financial system and regulatory arrangements, fusion of these agencies' functions and approaches would be premature;
- a single regulator with all of these functions might become excessively powerful; and
- these functions may be too extensive to be combined in one agency with full efficiency.

One further possibility has been raised in submissions to the Inquiry — that of a body charged with a role of overseeing, guiding and coordinating the financial regulatory agencies, such as a system wide policy board.

The Inquiry regards this general oversight role as belonging essentially to the Treasurer, as the Minister with responsibility for the financial system. The Treasurer's oversight role could not be devolved onto a system wide

board without creating a two-tier structure of regulatory agencies, which would introduce substantial costs and complications. The Inquiry believes that if the mechanisms for external review and coordination function as recommended, there will be no need for a system wide board.

12.7 Further Inquiries into the Financial System

In general, the time horizon of the analysis presented in this Report is from five to ten years.

The Inquiry's recommendations about individual regulatory agencies, and about external review and coordination of them, are made with the aim of ensuring continuous updating of the regulatory framework for the financial system. The revised regulatory framework would incorporate more systematic responses to new technology, adaptation to global and regional developments in capital markets, monitoring of cost effectiveness in financial system regulation, and coordination of the regulatory agencies. If such reforms are successful, periodic formal reviews of the financial system regulatory framework by special inquiries such as this would be unnecessary, or could be envisaged as infrequent strategic evaluations.

Accordingly, while further special inquiries into the financial system and its regulatory framework may be needed in the future, the Inquiry has not sought to recommend any fixed schedule or timing for such reviews.